No. 89-1965 (2)

In the Supreme Court of the United States

OCTOBER TERM, 1990

COTTAGE SAVINGS ASSOCIATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT

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10

QUESTION PRESENTED

Whether a financial institution realizes a deductible loss for income tax purposes when it exchanges a group of mortgage loans for a substantially identical group of mortgage loans held by another financial institution.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-15a) is reported at 890 F.2d 848. The opinion of the Tax Court (Pet. App. 16a-56a) is reported at 90 T.C. 372.

JURISDICTION

The judgment of the court of appeals (Pet. App. 57a) was entered on December 4, 1989. A petition for rehearing was denied on March 14, 1990 (Pet. App. 58a). The petition for a writ of certiorari was filed on June 11, 1990. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner is a mutual savings and loan association formerly regulated by the Federal Home Loan Bank Board. In 1980, petitioner's mortgage loan portfolio was partially comprised of fixed-rate, long-term mortgage loans that had been issued previously at interest rates significantly lower than those charged on more recent loans. As a result of the high interest rates of the early 1980s, the fair market value of these older, low-interest loans fell far below their face amount. Pet. App. 2a, 18a.

For petitioner, like other savings institutions holding older, low-interest loans, this situation created a tax incentive for disposing of its depreciated mortgage loans. A disposition of the loans would enable petitioner to realize for tax purposes the loss that resulted from these market changes; it could then utilize the resulting loss deductions to offset current taxable income and produce loss carrybacks that would generate tax refunds from prior years. There was, however, a catch. Many of these institutions were in such precarious financial condition that a sale of the loans and consequent recognition of the losses—however beneficial for tax purposes—would for regulatory accounting purposes have caused them to fail to meet the Bank Board's minimum reserve and liquidity requirements, raising the prospect of closure by the Bank Board. See Pet. App. 18a-19a; *San Antonio Savings Ass'n* v. *Commissioner*, 887 F.2d 577, 579 (5th Cir. 1989), petition for cert. pending, No. 89-1928.

On June 27, 1980, the Bank Board's Office of Examination and Supervision (OES) issued Memorandum R-49, a regulatory accounting principle that adopted the rule that savings institutions could make "reciprocal sales" of depreciated "substantially identical mortgage loans" without having to record a loss for regulatory accounting purposes. Memorandum R-49 established a list of criteria that would

render loans "substantially identical," including that the mortgages be of similar type with the same terms and interest rates.[1] The admitted objective of Memorandum R-49 was to allow savings institutions to engage in transactions that would generate deductible losses for federal income tax purposes, but that would not be treated as giving rise to losses for financial reporting and regulatory purposes. Pet. App. 19a-20a.[2]

2. On December 31, 1980, petitioner entered into four separate transactions with four other savings institutions designed to exchange interests in mortgages that satisfied

[1] Memorandum R-49 specifically provided in part (Pet. App. 19a-20a):

> A loss resulting from a difference between market value and book value in connection with reciprocal sales of substantially identical mortgage loans need not be recorded. Mortgage loans are considered substantially identical only when each of the following criteria is met. The loans involved must:
> 1. involve single-family residential mortgages,
> 2. be of similar type (e.g., conventionals for conventionals),
> 3. have the same stated terms to maturity (e.g., 30 years),
> 4. have identical stated interest rates,
> 5. have similar seasoning (i.e., remaining terms to maturity),
> 6. have aggregate principal amounts within the lesser of 2 1/2% or $100,000 (plus or minus) on both sides of the transaction, with any additional consideration being paid in cash,
> 7. be sold without recourse,
> 8. have similar fair market values,
> 9. have similar loan-to-value ratios at the time of the reciprocal sale, and
> 10. have all security properties for both sides of the transaction in the same state.

[2] A memorandum from the Director of OES to an officer of the Bank Board described the "objective" of Memorandum R-49 as "to structure a transaction which was as close as possible to the IRS 'materially different' definition which would still not change the economic position of the association after it engaged in the swap." Pet. App. 21a.

the requirements of Memorandum R-49. In each transaction, petitioner effectively exchanged a package of 90% participation interests in a group of mortgage loans for a package of 90% participation interests in a group of mortgage loans held by the other institution. Pet. App. 24a-27a, 32a-33a.[3] In each transaction, the participation interests exchanged were in loan packages having almost identical face and market value (*id.* at 25a), and the loans involved were "substantially identical" according to the criteria set forth in Memorandum R-49 (*id.* at 30a). In selecting loans to be exchanged, petitioner and its trading partners did not investigate the credit ratings of any of the borrowers on the loans it received and did not investigate the value of the real estate that secured the loans. *Id.* at 4a, 28a. The pricing or valuation of all the loans was established by using one common discount factor based on the then-current interest rate of 14.863%. *Id.* at 3a, 25a.

Each transaction was consummated in the form of a "reciprocal sale" by conveyance of the 90% participation interests together with a simultaneous transfer of checks by both parties in the amount of the fair market value of the interests acquired (Pet. App. 3a, 24a-25a). Petitioner paid a total of $4,456,912 and received a total of $4,458,855 in the four transactions (*id.* at 25a). The participation interests that it transferred had a face value of $6,907,208 (*id.* at 27a). On its 1980 federal income tax return, petitioner claimed a deduction for a loss on the transaction in the amount of the difference between the face value of the participation interests transferred and the amount received for them. Pursuant to Memorandum R-49, petitioner did not report any loss for financial and regulatory accounting purposes. *Id.* at 2a, 30a.

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[3] Transactions designed to take advantage of Memorandum R-49 often involved exchanges of 90% participation interests, rather than the entire loan, so that the original mortgagee could maintain its relationship with the obligor on the loans. Pet. App. 27a-28a.

3. On audit, the Commissioner determined that petitioner was not entitled to its claimed deduction for a loss on the mortgage exchange transactions. Petitioner sought redetermination of the resulting income tax deficiencies in the Tax Court. After a trial, the Tax Court held for petitioner (Pet. App. 16a-54a).

The Commissioner's primary argument was that a loss is "realized" for tax purposes under Section 1001 of the Internal Revenue Code (26 U.S.C.) on an exchange of property only if the exchanged properties are "materially different" and that mortgages that were "substantially identical" under the Memorandum R-49 criteria were not materially different. The Tax Court concluded that the loans taxpayer transferred were "materially different" from the loans it received because the loans had different borrowers and were secured by different collateral (Pet. App. 40a-45a). The Tax Court also rejected the Commissioner's argument that, because the mortgage exchange lacked economic substance, deduction of the loss was not authorized by Section 165 of the Internal Revenue Code (*id.* at 51a-53a).

4. The court of appeals reversed (Pet. App. 1a-15a). The court agreed with petitioner's position that a loss was "technically realized" (*id.* at 10a) on an R-49 exchange of mortgages because, in the court's view, Section 1001 of the Code does not require that exchanged properties be "materially different" in order for an exchange to constitute a realization event (*id.* at 9a-10a). The court held, however, that because the exchange of mortgages pursuant to Memorandum R-49 did not result in any real change in petitioner's economic position, petitioner had not "sustained" a loss on the transactions that would permit it to take a loss deduction under Section 165 of the Code (Pet. App. 10a-15a). In particular, the court stated that loss deductions are not allowed on "transactions in which the taxpayer's economic position was not changed for the worse"

(*id.* at 12a-13a), and it concluded that petitioner's "economic position was not changed" by an exchange of a pool of mortgages for "a substantially identical pool of mortgages" (*id.* at 14a).

DISCUSSION

This case presents the same question that is presented in three petitions pending from decisions of the Fifth Circuit (*United States* v. *Centennial Savings Bank (Resolution Trust Corporation, Receiver)*, No. 89-1926 (Question 1); *United States* v. *First Federal Savings and Loan Ass'n*, No. 89-1927; *Commissioner* v. *San Antonio Savings Ass'n and Subsidiaries (Resolution Trust Corporation, Receiver)*, No. 89-1928), and in a petition pending from a decision of the District of Columbia Circuit (*Commissioner* v. *Federal National Mortgage Ass'n*, No. 89-1987) – namely, whether a financial institution realizes a deductible loss for income tax purposes when it exchanges a group of mortgage loans for a "substantially identical" group of mortgage loans. As we explain in detail in our petition in *Centennial*, review of this question by this Court is warranted because there exists a square conflict in the circuits between the decision below and the decisions of the Fifth and District of Columbia Circuits (see *Centennial* Pet. 11-13) and the issue is of considerable importance to the administration of the federal tax laws. [4] We have accordingly urged that the Court grant plenary review in *Centennial* and in *First Federal* (see *Centennial* Pet. 13 n.10). Because the question presented here is the same as that already presented in *First Federal* and in *Centennial*, we believe that there is no need for the Court to grant plenary review in this case as well but that

[4] We are supplying petitioner's counsel with copies of our petitions in *Centennial*, *First Federal*, *San Antonio*, and *Federal National Mortgage Ass'n*.

it would be appropriate for the Court to hold this case pending the outcome in *Centennial* and *First Federal*.

CONCLUSION

The petition for a writ of certiorari should be disposed of as appropriate in light of this Court's disposition of *United States* v. *Centennial Savings Bank (Resolution Trust Corporation, Receiver)*, No. 89-1926, and *United States* v. *First Federal Savings & Loan Ass'n*, No. 89-1927.

Respectfully submitted.

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* The Solicitor General is disqualified in this case.

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